

No. 11881

IN THE

United States Circuit Court of Appeals  
FOR THE NINTH CIRCUIT

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MARLBOROUGH CORPORATION,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

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Upon Appeal from the District Court of the United States for  
for the Southern District of California

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BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

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**Opinion Below.**

The District Court wrote no opinion.

**Jurisdiction.**

This appeal involves federal income taxes paid for the years 1939 and 1940. The taxes in dispute were paid on July 31, 1942, as the result of the assertion of a deficiency by the Commissioner of Internal Revenue. [R. 3-4, 13, 24-26.] Claim for refund was filed on August 7, 1943, and was rejected by notice dated November 5, 1943. [R. 6, 13, 26.] Within the time provided in Section 3772 of the Internal Revenue Code and on June 28, 1944, the taxpayer brought an action in the District Court for recovery of the taxes paid. [R. 12, 27.] Jurisdiction was conferred on the District Court by Section 24, Twentieth, of the Judicial Code. The judgment was entered on August 30, 1947. [R. 30.] Notice of appeal was filed on November 25, 1947 [R. 31], pursuant to the provisions of Section 128(a) of the Judicial Code, as amended.

### Question Presented.

Was the finding of the District Court that the taxpayer was availed of for the purpose of preventing the imposition of surtaxes upon its shareholders during each of its taxable years ending August 31, 1939, and August 31, 1940, clearly erroneous, under Section 102 of the Revenue Act of 1938 and the Internal Revenue Code?

### Statutes and Regulations Involved.

These will be found in the Appendix *infra*.

### Statement.

The facts set forth in this statement are taken from the findings of the District Court. [R. 23-28.]

The taxpayer brought this action on June 28, 1944, to recover income taxes assessed and collected under the direction of the Commissioner of Internal Revenue. [R. 23-27.]

The taxpayer, a California corporation owning school properties but having its principal place of business at 735 Roosevelt Building, Los Angeles, duly filed its income tax returns for its fiscal years ending August 31, 1939, and August 31, 1940.<sup>1</sup> [R. 23, 24, 25, 28.] On July 7, 1942, the Commissioner of Internal Revenue asserted deficiencies in corporate income tax of \$3,389.55 for 1939 and \$6,036.49 for 1940. [R. 24, 25.] These sums, together with interest thereon, were paid by the taxpayer on July 31, 1942, to a Collector of Internal Revenue who is no longer in office. [R. 23, 24, 25-26.] The 1939 deficiency was based upon a liability for surtaxes

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<sup>1</sup>Hereinafter the taxable years will be referred to as 1939 and 1940.

under Section 102 of the Revenue Act of 1938. [R. 24.] The 1940 deficiency, to the extent of \$924.46, was based upon the disallowance of excessive depreciation deductions in the taxpayer's return for that year, and to the extent of \$5,112.03 was based upon liability for surtaxes under Section 102 of the Internal Revenue Code. [R. 25.]

The taxpayer filed claims for refund of these taxes on August 7, 1943, and the claims were disallowed by the Commissioner on November 5, 1943. [R. 26.]

During the course of the trial taxpayer abandoned its claim for the \$924.46 tax deficiency and interest thereon, which had resulted from the disallowance of depreciation deductions for 1940. [R. 27.]

The District Court found that the taxpayer corporation was not formed for the purpose of preventing the imposition of surtaxes upon its shareholders. [R. 27.] It found, however, as a fact, that the taxpayer was availed of for the purpose of preventing the imposition of surtaxes upon its shareholders during each of its taxable years ending August 31, 1939, and August 31, 1940. [R. 27.]

In 1939 the corporation had a taxable net income of \$37,337.55 and distributed dividends amounting to only \$17,500, of which amount \$15,000 was used to purchase a ranch for the stockholders' son. In 1940 the corporation's taxable net income was determined by the Commissioner to be \$26,408.50 and in that year dividends of only \$2,500 were distributed. In 1933 taxpayer's surplus account had a balance of \$153,927.78. In 1940 it had a balance of \$213,632.92. On August 31, 1940, it had

investments in securities having a book cost of \$157,093.29 and a fair market value of \$114,125. As a result of the accumulation in the taxable years here involved, taxpayer's two shareholders avoided surtax in their personal income tax of \$2,402.99 in 1939 and \$4,199.68 in 1940. [R. 27-28.]

The court also found as a fact, that in 1946 the school properties owned by taxpayer were in good repair and had not been substantially altered since 1939 and 1940 but had been modernized. The properties were being used in 1946 for substantially the same school purposes as they had been during 1939 and 1940 with the exception that boarding school activities formerly carried on by the lessee of the properties had been abandoned. [R. 28.]

It was further found that during the two taxable years in question taxpayer conducted no substantial activities other than the management of its investments and the receiving of rentals from the lessee of the school properties, the lessee paying the taxes on the properties. However, the lease did provide for some consultations between the taxpayer and the school operator. [R. 28.]

The District Court concluded as a matter of law that the taxpayer was a holding company within the meaning of Section 102 of the Internal Revenue Code during each of the taxable years. [R. 28.]

It concluded as a matter of law that during each of the tax years 1939 and 1940 taxpayer was availed of for the purpose of preventing the imposition of the surtax

upon the income of its shareholders through the medium of permitting its earnings and profits to accumulate instead of being divided or distributed. [R. 29.]

It held that the taxpayer had not proved there was no purpose to avoid the imposition of surtax on the income of its shareholders. [R. 29.]

It then granted judgment in favor of the Government. [R. 29.]

### **Summary of Argument.**

The District Court found as a fact that the taxpayer was availed of for the purpose of preventing the imposition of surtaxes upon its shareholders through the medium of permitting its earnings and profits to accumulate. This finding was supported by substantial evidence and was not clearly erroneous. The taxpayer was a family-owned corporation having a large surplus most of which was represented by cash and investments unrelated to the business. The taxpayer's two stockholders had independent incomes and did not require distribution of the taxpayer's earnings. During the taxable years taxpayer distributed comparatively small parts of its earnings to its stockholders and they thereby managed to avoid substantial amounts in surtaxes.

Taxpayer's controlling stockholder, a lawyer, sought to establish that although he did avoid surtaxes he did not have that purpose but was merely attempting to build corporate reserves to meet specified contingencies, most of which were set forth in contemporaneous memoranda.

The trial court could properly find, however, that: the alleged contingencies were remote and speculative; the reserves and the stockholder's explanations of them were patently unreasonable; his actions were inconsistent with his stated purpose; the memoranda were mere blinds designed to mask the taxpayer's actual purpose; the stockholder's testimony was unworthy of belief because some of his statements made under oath were obviously untrue; and the stockholder did have the purpose he denied.

The taxpayer was merely an incorporated family pocket-book which its two stockholders used as a depository for their surplus funds obtained from the taxpayer's income as lessor of a school and as loans from the stockholders. It permitted them to invest in stocks and bonds and retain the profits in the corporate treasury without payment of surtax on individual income, and to draw only such funds as were needed.

The District Court's finding that taxpayer was a mere holding company also provided *prima facie* evidence as a matter of law of the taxpayer's purpose to avoid surtax on the stockholders. This finding likewise was not erroneous.

The District Court did not make any finding as to whether the taxpayer had or had not allowed its earnings to accumulate beyond the reasonable needs of the business because it was unnecessary for it to do so. The evidence showed the taxpayer's purpose without necessity for statutory presumption.

## ARGUMENT.

### The Finding That Taxpayer Was Availed of for the Purpose of Preventing Surtax on Its Stockholders Was Not Erroneous.

#### A. THERE WAS SUBSTANTIAL EVIDENCE TO SUPPORT THE FINDING.

The District Court found as a fact that the taxpayer was availed of for the purpose of preventing the imposition of surtaxes upon its shareholders during each of its taxable years 1939 and 1940. [R. 27.] We submit, contrary to the taxpayer's arguments, that there was substantial evidence before the Court to support the finding and that it was not clearly erroneous.

The evidence showed that the taxpayer was a corporation engaged principally in the business of holding and renting school property to a school known as Marlborough School for Girls operated by another. [R. 21.] Although its capital was only \$50,000 it had accumulated at the end of its tax year 1939 a surplus of \$194,344.60 and at the end of 1940 a surplus of \$213,632.92. [R. 27, 230, 239.] As of such dates it had invested in securities unrelated to the leasing of its school property, \$146,493.36 and \$157,093.29,<sup>2</sup> respectively, and had remaining cash of \$19,417.09 and \$39,679.84, respectively, as well as other assets. [R. 27, 98-99, 229.] For 1939 it had taxable net income of \$37,337.55 and for 1940 it had \$26,408.50.<sup>3</sup> [R. 27.] However, during 1939 it dis-

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<sup>2</sup>Their market values were lower than what the taxpayer had put into them. At the end of 1939 they were worth \$108,245, and at the end of 1940 \$114,125.

<sup>3</sup>In taxpayer's brief (p. 4) the taxable income for 1940 is set forth as \$21,870.32. This omits the Commissioner's adjustment of \$4,538.18 for excessive depreciation which taxpayer conceded to be correct. [R. 8, 20, 27.]

tributed in dividends only \$17,500 (\$15,000 of this being used to purchase a ranch for taxpayer's stockholders' son) and in 1940 it distributed only \$2,500. [R. 27.]

The taxpayer was wholly owned by two shareholders, Eugene and Georgia C. Overton, a husband and wife, each of whom had independent income from other sources and did not require distribution of the taxpayer's income. [R. 64, 77, 83, 96, 182, 198.] Eugene Overton, who managed the financial affairs of the business [R. 36], was a practicing attorney of many years experience who had had numerous occasions to deal with tax matters and was aware that the payment of dividends by the taxpayer corporation would subject him to increased surtaxes [R. 67-68, 201]. As a result of accumulating the corporate income during the taxable years instead of distributing it, taxpayer's two shareholders avoided surtaxes on their personal incomes of \$2,402.99 in 1939 and \$4,199.68 in 1940. [R. 28, 239.]

The foregoing facts are typical of cases in which the courts have found that closely held corporations have been availed of by their stockholders to prevent the imposition of surtax upon themselves through not distributing corporate earnings. Cf. *Helvering v. Nat. Grocery Co.*, 304 U. S. 282; *Helvering v. Stock Yards Co.*, 318 U. S. 693; *Trico Products Corp. v. Commissioner*, 137 F. (2d) 424 (C.C.A. 2d); *McCutchin Drilling Co. v. Commissioner*, 143 F. (2d) 480 (C.C.A. 5th); *Semagraph Co. v. Commissioner*, 152 F. (2d) 62 (C.C.A. 4th); *R. L. Blaffer & Co. v. Commissioner*, 103 F. (2d) 487 (C.C.A. 5th); *Wilson Bros. & Co. v. Commissioner*, 124 F. (2d) 606 (C.C.A. 9th).

Taxpayer attempted to prove that even though it succeeded in avoiding surtax on its stockholders taxpayer

did not have that purpose in accumulating its income and failing to distribute more substantial dividends during 1939 and 1940. Eugene Overton testified as to certain specified needs of the business which had prompted the accumulations in 1939 and 1940. [R. 36-99, 175-200.] And as evidence of his purpose to accumulate a reserve to meet these business needs, he identified two memoranda setting forth such needs, which he claimed to have made as far back as 1937 and 1939. [R. 38, 257-259.]

The trial court was not obligated however, to accept the taxpayer's denials of the purpose to prevent the imposition of surtax on the stockholders in accumulating its income. It could find from all the evidence in the record that such was in fact its actual purpose. *Helvering v. Stock Yards Co.*, *supra*; *Helvering v. Nat. Grocery Co.*, *supra*; *Wilkerson Daily Corp. v. Commissioner*, 125 F. (2d) 998 (C.C.A. 9th).

Overton testified that one of the principal purposes of the corporation in accumulating income during 1939 and 1940 was to provide a fund for rebuilding at greater cost than that of the original buildings in the event it became necessary to move the school to another location. [R. 37, 50-51, 53, 185-186.] He claimed that a westward shift in the population from which the school drew its pupils required the school to move west. [R. 6, 50-51, 185-186.] However, Overton admitted that during the tax years at issue no tabulation as to any shifting student body had been made [R. 51, 77-80]; he did not know during the tax years nor at time of trial when such a move would

become necessary, where it would be, nor how much it would cost [R. 51, 53]; nor did he find it unreasonable to conclude that most of the students still came from within the area of a few blocks surrounding the school and not from any distance. [R. 80.] Taxpayer introduced no evidence that as of 1939 and 1940 the student population showed any tendency whatsoever to fall off. What evidence there was in the record showed as a matter of fact that the number of students attending the school was increasing. [R. 238.] And, as taxpayer points out in its brief (p. 6), during 1939 the corporation had its best earnings in many years.

Moreover, the evidence also showed that at any time after September 1, 1940, the lessee of the school property, under a lease which the taxpayer hoped would be renewed beyond 1942 [R. 196], had the option to buy the entire school business (other than the real estate), including the good will and the right to use its name, for a mere \$25,000 [R. 249-251]. Thus, apart from the other evidence, during 1939 and 1940 taxpayer could have hardly had even a remote or nebulous intention to invest many times that sum in new land and buildings, when if the school were successful enough to justify its continuance the lessee might well conclude to do so herself.

In 1937, Overton testified, he drew up a pencil memorandum of the business needs of the taxpayer which required the accumulation of earnings. [R. 38, 177.] This memorandum purported to show such business needs as follows [R. 257-258]:

# POLICY MEMO RE RESERVE FUND.

It has been for many years and still is the purpose of the stockholders and directors of Marlborough Corporation to accumulate and establish a reserve fund in cash and/or liquid securities to provide for probable future business requirements and contingencies.

So far as can be foreseen at the present time, these probable business requirements and contingencies are believed to be as follows:

(1) Possible fire loss not compensated for by insurance, estimated at.....	\$ 20,000.00
(2) Remodeling buildings in the event it is decided to eliminate the boarding department, and for other contingencies, estimated at.....	15,000.00
(3) Additions to buildings, or new buildings that may be required, estimated at.....	35,000.00
(4) To provide for working capital if the present lease on the School should be terminated.....	50,000.00
(5) To provide for obsolescence and depreciation .....	67,000.00
(6) To provide for earthquake damage, as no earthquake insurance is carried, estimated at.....	20,000.00
(7) Indebtedness to Mark Overton, Georgia C. Overton and Eugene Overton .....	35,000.00
	<hr/>
	\$242,500.00

In order to gradually accumulate this reserve fund it is the policy to pay very moderate dividends until the reserve fund is established.

A similar memorandum drawn by Overton under date of November 7, 1939, stated however, that there was need for a reserve fund of only \$215,000. It also varied from the first memorandum in that the amount stated to be for obsolescence and depreciation was \$75,000 instead of \$67,000, and there was omitted entirely the item of \$35,500 relating to the indebtedness owed the Overtons. [R. 258-259.]

It was in pursuance of the estimated needs shown in these memoranda that the accumulations in 1939 and 1940 were alleged to have been made. [R. 38.]

The first item in the memoranda was the estimate of \$20,000 for "Possible fire loss not compensated for by insurance." [R. 257, 258.] Overton stated that this sum was intended to cover any possible total loss in excess of fire insurance. [R. 39, 178.] The testimony of taxpayer's own witnesses was however, that one of the two school buildings which would cost \$75,000 to rebuild was almost fireproof [R. 116] and that the other would cost \$255,188 to replace if destroyed [R. 115]. To meet this contingency, the evidence showed, taxpayer had \$173,285.21 in accumulated reserve for depreciation on both buildings at the close of 1939 and \$180,582.31 at the close of 1940 [R. 229], \$190,765 in fire insurance [R. 39], and \$119,000 in contingency insurance to cover the difference between original cost and any higher cost of replacement [R. 39]. In addition, there was the \$67,000 in earnings and profits alleged to have been accumulated for additional depreciation in accordance with the taxpayer's memorandum (\$75,000 in the second memorandum) [R. 257, 259], which, if truly set aside for that purpose, would likewise have been available in the event of fire loss. And the same use could likewise have been

made of the reserve for \$35,000 owed the Overtons and other items. [R. 257.] The trial court could therefore have properly concluded that the taxpayer's investment in its buildings was already adequately protected in the event of fire and the estimated need of a \$20,000 additional reserve was not in good faith.

There was set forth in Overton's memoranda the sum of \$35,000 for "Additions to buildings, or new buildings that may be required." [R. 257, 258.] Overton testified that there was included in this sum the expense of contemplated remodeling and modernizing the gymnasium but could not recall any other items. [R. 41, 179.] Under the lease in effect during 1939 and 1940 taxpayer had no power to make additions to the property. [R. 106.] But the taxpayer introduced no evidence that any new buildings or additions to buildings were even contemplated at any time. And at the time of trial no new buildings or additions had been built. [R. 41, 109, 179.]

The sum of \$50,000 was included in Overton's memoranda "To provide for working capital if the present lease on the School should be terminated." [R. 257, 259.] In his testimony Overton stated that in 1939 and 1940 he determined to accumulate this money so as to be able to use it during the summer of 1942 for minor repairs, painting and teachers' salaries if the lease should be terminated and the corporation should take over active operation of the school for the fall term. [R. 96, 179, 180, 182.] However, the evidence showed that the lessee and not the taxpayer was liable for repairs and painting at the end of the school year in 1942 [R. 72, 74, 181] and by its terms the lease was not to terminate until September of 1942 [R. 182]. What salaries were required to be paid until the tuition was collected could just as readily have

been paid from any other money set aside and needed no special reserves. Moreover, in the taxpayer's sworn claim for refund Overton stated under oath that the amount required for these purposes was only \$22,300 and not \$50,000. [R. 70-72.] And, furthermore, while in the sworn complaint Overton stated under oath that "During the years in question it was *definitely known* that the lease under which the business had formerly been operated by a lessee using her own working capital was to be terminated within a year" (emphasis supplied) and therefore, taxpayer undertook to accumulate working capital sufficient to operate the business [R. 5-6, 10], he admitted on the witness stand that during 1939 and 1940 he had no right to break the lease even if he had wanted to do so, that he had not decided whether at its expiration he would renew or terminate it and did not decide until 1942, and that he had hoped that he would be able to renew it at that time [R. 50, 75, 76, 196].

In the first memorandum Overton had included for additional depreciation the sum of \$67,000, and in the second the sum of \$75,000. [R. 257, 259.] In his testimony he explained that this item was to cover the increased cost of rebuilding the school buildings beyond the reserves for depreciation, after they had fully depreciated. [R. 41, 44, 183.] The regular reserves for depreciation on most of the property, which appeared on the books, totalled \$173,285.21 at the end of 1939 and \$180,582.31 at the end of 1940. [R. 229.] In the verified complaint Overton stated under oath that "A large part of the useful lives of the assets used in plaintiff's business, particularly its buildings, was exhausted; many of such assets were in a deteriorated condition, outmoded and insufficient in capacity and facilities for the proper con-

duct of plaintiff's business and required replacement as soon as financial and building conditions warranted." [R. 5, 9.] But according to the data produced by the taxpayer even its own books showed a remaining life for its frame school building of at least seven years and for its concrete auditorium of about 23 years. [R. 184, 237.] Overton admitted, moreover, that book depreciation reserves did not necessarily show the property was actually depreciated to that extent.<sup>4</sup> [R. 52.] Taxpayer's witness Hugh L. Mann estimated that the buildings could be used for the same purposes until at least 1950 (when certain deed restrictions came into effect). [R. 139.] Worn out furnishings and fittings were required to be renewed by the lessee. [R. 242.] And even in 1946 the trial court found from its own detailed observation and examination that the school properties were in good repair, were being used for substantially the same purposes as they had been used in 1939 and 1940 and the taxpayer had even modernized them without substantial alteration. [R. 28.]

Overton conceded that during the tax years his alleged plans for replacing the buildings were never definite enough so as to warrant consulting architects or engineers as to what a new building would cost and all he knew was that it would cost more than the original. [R. 81-82.] The trial court could therefore properly find from the evidence that as of 1939 and 1940 taxpayer could have looked forward to many years more of earnings before the need for replacing its buildings would become pressing and that the taxpayer knew this to be so. Therefore the taxpayer's claimed need for accumulating earnings during

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<sup>4</sup>As an example of this the books showed the carpets to be fully depreciated in 1939 and 1940; but Mrs. Overton admitted they were in good condition during those years. [R. 52, 103, 237.]

1939 and 1940 for replacing its buildings did not preclude an intent to prevent the imposition of surtax on the stockholders at the same time.

The \$20,000 item appearing in the memoranda, to provide for earthquake damage [R. 257, 259] was admitted by Overton not to have been based on any real estimate but was merely a guess [R. 82], and if an earthquake occurred obviously he had no way of knowing whether it would cause damage to the property of \$20,000 or 20 cents or \$200,000.

The provision for \$35,000 to pay the indebtedness owed Mark, Georgia, and Eugene Overton appears in the earlier memorandum only and not in that of 1939. [R. 257, 259.] The evidence showed, however, that this money had been owed by the taxpayer since 1925 [R. 54-55], and although the taxpayer could have repaid it at any time with cash or securities on hand [R. 62], it never did but merely renewed the debts from time to time [R. 63, 188] and continued to pay seven per cent interest on them to the Overtons [R. 62]. Overton's only explanation for this was that he wanted to keep a large bank balance in the Marlborough account. [R. 63.] Since the corporation could have had no actual need for the money but merely invested it in securities, the court could properly have concluded that the taxpayer had no real intention of accumulating earnings to pay back these loans but was using the funds in the same manner as the Overtons would have in their own name with the exception that the profits on the securities bought by the corporation were not subject to the surtax on individual income and the seven per cent interest payments were deductible by the corporation from its income.

In addition to the flaws and discrepancies shown in the explanation of the individual items in the taxpayer's memoranda, other reasons were apparent why both the memoranda and Overton's testimony thereon should not have been taken at their face values.

The sums in the memoranda were set forth as cumulative needs, for the total of which taxpayer was required to and did accumulate its earnings during 1939 and 1940. It seems evident, however, that even on their face not all the alleged needs required separate or additional allocation of funds. Thus, if the school burnt down the funds set aside for additional obsolescence and depreciation, for earthquake damage and for the Overton debts could be used for the rebuilding. The working capital for the summer renovations and teachers' salaries prior to the first year's operations after the end of the lease could be gotten from any of the other reserves and paid as a current expense from tuitions. If earthquake damage occurred it could be taken care of by unused reserves for fire loss or the additional depreciation or the Overton debts.

Overton testified that the taxpayer had followed the policy of accumulating its surplus for the purposes discussed since 1934. [R. 37, 176.] And yet if this were the case and if the corporation were anxious to build up its funds to meet the various contingencies Overton enumerated, it would not very likely have been willing to pay \$2,485 in interest each year (or almost \$25,000 since at least 1931) to its two stockholders and their son for the use of \$35,000 as loans which it did not need and which it could have repaid at any time. [R. 54, 55, 62, 188, 230.] And if its purpose were actually to strengthen its financial position it was certainly peculiar that the

Overtons were willing to pay out of corporate funds to their son upon his marriage \$5,000 because they personally had a moral obligation to him [R. 60], and that they were willing to declare and pay an extra dividend of \$15,000 in 1939 merely because they wished to buy a \$15,000 ranch for him<sup>5</sup> [R. 66, 190]. Nor was it consistent with the stated purpose for accumulating the earnings for the taxpayer to invest the surplus funds in securities of a speculative nature chosen from the standpoint of whether they were liable to increase in value, their yield being merely a secondary consideration. [R. 97.]

The trial court could properly have found that the variances between some of the statements made under oath by the witness Overton in the verified complaint and the evidence produced at trial rendered his entire testimony unworthy of belief.<sup>6</sup>

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<sup>5</sup>Compare the treatment of similar inconsistencies as a factor in determining the taxpayer's actual purpose in *Helvering v. Nat. Grocery Co.*, 304 U. S. 282, 292; *J. M. Perry & Co. v. Commissioner*, 120 F. (2d) 123, 125 (C.C.A. 9th); *Wilkerson Daily Corp. v. Commissioner*, 125 F. (2d) 998, 1000 (C.C.A. 9th); *Semagraph Co. v. Commissioner*, 152 F. (2d) 62 (C.C.A. 4th).

<sup>6</sup>In the complaint Overton stated [R. 5]:

- (1) A large part of the useful lives of the assets used in plaintiff's business, particularly its buildings, was exhausted; many of such assets were in a deteriorated condition, outmoded and insufficient in capacity and facilities for the proper conduct of plaintiff's business, and required replacement as soon as financial and building conditions warranted.

The trial court found, however, that the properties of the school were in good repair. [R. 28.] Taxpayer admits this finding to be correct. (Br. 39-40.)

In the complaint Overton stated [R. 5-6]:

- (4) During the years in question it was definitely known that the lease under which the business had formerly been

The trial court could properly have found that Overton's testimony even as to the circumstances of the drawing of the memoranda was not worthy of credence. At several places in the record he stated that the memoranda as to needs for accumulation of earnings had been drawn purely for his own satisfaction merely to verify in his own mind his conclusion that the corporation should accumulate at least \$250,000 in reserve funds and that accordingly it had not been drawn in any detail or with the thought that it would ever be made public, and if he had thought it would be made public he would have drawn it in greater detail. [R. 39, 57, 186.] He also testified, however, that they had been drawn because it was feared he and his wife might be drowned at sea and he desired to give his son a record upon which to base his actions. [R. 43, 195.] How the same memoranda could have been intended to serve both entirely different purposes was not explained.

From all of the foregoing the trial court could properly have concluded that the taxpayer's explanations for its accumulation of earnings were too patently unreasonable to be worthy of belief and that its memoranda were

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operated by a lessee using her own working capital was to be terminated within a year. Plaintiff therefore undertook to accumulate working capital sufficient to operate the business on its own behalf.

At the trial he testified, however, that during the tax years at issue he was not decided whether to renew the lease or not and did not make up his mind until 1942. [R. 50, 75, 76, 196.]

In the complaint Overton stated [R. 6]:

- (5) Changing conditions and shifts in the population of Los Angeles made it advantageous and a business necessity to move rather than rebuild the school at its then location.

At trial he testified, however, that he did not know during the tax years or even at time of trial when it would become necessary to move the school. [R. 51, 53.]

merely elaborate blinds designed to mask the purpose to accumulate earnings to avoid surtax on its two shareholders.

The entire evidence before the court could amply have justified it in concluding that the taxpayer was merely a "family pocketbook" which its two stockholders used as a depository for their surplus funds obtained from the leasing of the Marlborough School and directly from the stockholders, and from which they had no occasion to draw except for specific needs. As Eugene Overton testified, he merely wanted a yield of \$1.25 per year per share. [R. 64.] It permitted the Overtons to deal and invest in stocks and bonds and retain the profits in the corporate treasury exactly as if they owned them directly but without necessity for payment of surtax on individual income. Unquestionably this is one of the things which Section 102 (Appendix, *infra*) was designed to prevent. *R. L. Blaffer & Co. v. Commissioner, supra*; *Rands, Inc. v. Commissioner*, 34 B.T.A. 1094, appeal dismissed, 101 F. (2d) 1018 (C.C.A. 6th); *Reynard Corp. v. Commissioner*, 37 B.T.A. 552.

B. THE FACT TAXPAYER WAS A MERE HOLDING COMPANY WAS PRIMA FACIE EVIDENCE OF A PURPOSE TO AVOID SURTAX ON ITS STOCKHOLDERS.

While it is submitted that the evidence fully supported the trial court's finding that the taxpayer was availed of for the purpose of preventing the imposition of surtax upon its stockholders even without the benefit of statutory presumption, further and *prima facie* evidence of purpose arises as a matter of law under Section 102 of the Internal Revenue Code (Appendix, *infra*) from the conclusion that during the tax years at issue taxpayer was a mere holding company. [R. 28.]

Section 102(b) provides:

The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.

Treasury Regulations 103 under the Internal Revenue Code, Section 19.102-2 (Appendix, *infra*), provide:

A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon the market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.<sup>7</sup>

The trial court found that during 1939 and 1940 taxpayer conducted no substantial activities other than the management of its investments and the receiving of rentals from the lessee of the school properties. [R. 28.] While conceivably this finding could have given rise to the conclusion of law that taxpayer was an investment company rather than a holding company, the effect of either conclusion was the same under the statute. Either was *prima facie* evidence that the corporation was availed of for the critical purpose. The essence of the matter is that the taxpayer was not engaged in the operation of an active business.

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<sup>7</sup>Similar provisions have appeared in the various Treasury Regulations dealing with income taxes since 1918. See, *e. g.*, Treasury Regulations 45 under the Revenue Act of 1918, Article 352.

The finding that the taxpayer conducted no substantial activities other than managing its investments and receiving rentals was supported by substantial evidence. The lessee had been operating the school since 1925. [R. 240.] The lease provided that the lessee "shall have the entire control and management of the school in all its branches and departments without interference by the Lessor." [R. 248.] Under the lease the taxpayer could not even alter or repair the property. [R. 106.] While it was true that the lease provided for certain consultations to be held between the taxpayer and the school operator [R. 28], they pertained to any fundamental changes which the lessee might have contemplated in the leased business and property which might adversely affect the taxpayer's income from the lease and the value of its property [R. 84-91, 248-249]. Both Eugene Overton and his wife had leased the school property almost immediately on their acquisition of stock ownership in 1925 [R. 36-37, 240], and could therefore hardly be assumed to be expert in its operation. Neither of the Overtons received any salary from the taxpayer for services of any kind, nor were there any other employees. [R. 198, 231.] Overton testified that he had rented to the lessee a going concern. [R. 93.] Mrs. Overton testified that the corporation had nothing to do with the upkeep of the school other than objecting to expenses. [R. 101.] Under all the circumstances the trial court could properly have concluded that the activities of the taxpayer other than holding the property and receiving its income, in addition to managing its investments, were insubstantial. Cf. *R. & L., Inc. v. Commissioner*, 33 B.T.A. 857, affirmed, 84 F. (2d) 721 (C.C.A. 5th), certiorari denied, 299 U. S. 588; *Rcyndard Corp. v. Commissioner*, *supra*; *Stanton Corp. v. Commissioner*, 44 B.T.A. 56, affirmed, 138 F.

(2d) 512 (C.C.A. 2d); *Rands, Inc. v. Commissioner*, *supra*.

The case of *Higgins v. Commissioner*, 312 U. S. 212, cited by taxpayer as a leading case (Br. 16), has nothing to do with the instant issue or statute and involved wholly different considerations.

Taxpayer argues (Br. 18) that even if it is held that the trial court properly found it to be a mere holding or investment company, the effect of such finding was merely a presumption which disappeared as soon as taxpayer offered evidence contrary to the ultimate issue involved. The argument overlooks the language of the statute which provides that the finding shall be "*prima facie* evidence." Both the Treasury Regulations (Appendix, *infra*) and the authorities have treated the *prima facie* evidence under the instant statute as evidence of the ultimate issue, which the taxpayer has the burden of disproving and which may be weighed together with all the other evidence. *Helvering v. Nat. Grocery Co.*, *supra*; *J. M. Perry & Co. v. Commissioner*, 120 F. (2d) 123, 125 (C.C.A. 9th); *Trico Products Corp. v. Commissioner*, *supra*; *R. L. Blaffer & Co. v. Commissioner*, *supra*; *Suffolk Securities Corp. v. Commissioner*, 41 B.T.A. 1161, affirmed, 128 F. (2d) 743 (C.C.A. 2d). Taxpayer's reliance on *Hemphill Schools v. Commissioner*, 137 F. (2d) 961 (C.C.A. 9th) (Br. 19), is misplaced, since the court there was dealing merely with the presumption that the determination of the Commissioner was correct and not with a finding which the statute declares to be *prima facie* evidence. In *J. M. Perry & Co. v. Commissioner*, *supra*, the court appeared to regard the effect of the trial court's finding of fact sufficient to constitute *prima facie* evidence, if sustained, as conclusive on appeal.

C. DUE REGARD MUST BE GIVEN TO THE OPPORTUNITY OF THE TRIAL COURT TO JUDGE OF THE CREDIBILITY OF THE PRINCIPAL WITNESS AND TO VIEW THE EVIDENCE.

Rule 52(a) of the Rules of Civil Procedure for the District Courts of the United States provides in part:

Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.

In *Wittmayer v. United States*, 118 F. (2d) 808, 811 (C.C.A. 9th), this court stated in interpreting Rule 52(a) that—

so far as the findings of the trial judge who saw the witnesses “depends upon conflicting testimony or upon the credibility of witnesses, or so far as there is any testimony consistent with the finding, it must be treated as unassailable.”

Similarly in *United States v. Aluminum Co. of America*, 148 F. (2d) 416, 433, the Court of Appeals for the Second Circuit held that when a trial judge has seen the witnesses—

and in so far as his findings depend upon whether they spoke the truth, the accepted rule is that they “must be treated as unassailable.” \* \* \* and upon an issue like the witness’s own intent, as to which he alone can testify, the finding is indeed “unassailable,” except in the most exceptional cases.

In the instant appeal taxpayer argues (Br. 28) that “this case was submitted largely upon the basis of stipulations, and the record made before Judge Hollzer” and that

nothing new was developed before Judge Weinberger who decided the case after Judge Hollzer's death. But taxpayer neglects to note that in a joint pre-trial memorandum submitted at a pre-trial conference held before Judge Weinberger the taxpayer represented to the court as follows [R. 20-21]:

It is believed \* \* \* the ultimate decision in this case must be determined by the court's opinion as to the credibility to be accorded to the witnesses Eugene Overton and Georgia Overton \* \* \*.

Thereafter the court requested an oral statement of Eugene Overton's position. [R. 175.] And Eugene Overton restated before Judge Weinberger a considerable portion of the testimony he had given at the previous hearing. [R. 175-201.] The court did not regard such testimony as merely repetitious. It refused to agree to a stipulation striking it out and stated [R. 204]:

I don't know that I would concur in that stipulation. I have had a chance to size up Mr. Overton. I like to see a witness personally and then I get a better idea of who he is and what he is thinking about.

The trial court thus had a greater opportunity than this court to assess the credibility of the witness.<sup>8</sup>

Moreover taxpayer fails to mention that Judge Weinberger had before him prior to the decision of the case a fairly extensive view and inspection of the school premises.<sup>9</sup> [R. 15-19.] Since the taxpayer gave as one of

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<sup>8</sup>It has been submitted, *supra*, that even from the written record the credibility of the witness Overton is open to question.

<sup>9</sup>This was of course proper evidence under California law. *Gibson Properties Co. v. City of Oakland*, 12 Cal. (2d) 291, 83 P. (2d) 942; *People v. Milner*, 122 Cal. 171, 54 Pac. 833. And see 4 Wigmore on Evidence (4th ed.), Sec. 1168, and 7 Cyclopedia of Federal Procedure (2d ed.), Sec. 3292.

major reasons for the accumulations at issue a need for replacing the school buildings which were alleged to be deteriorated and whose useful lives were claimed to be exhausted [R. 5, 9], it can hardly be argued now that the court's examination of the buildings to verify whether or not taxpayer's contentions and Eugene Overton's testimony as to his purpose were in good faith was of no importance and can be disregarded by the appellate court.

D. THE TRIAL COURT HAD NO OCCASION TO FIND WHETHER THE EARNINGS WERE OR WERE NOT ACCUMULATED BEYOND THE REASONABLE NEEDS OF THE BUSINESS.

Among the taxpayer's arguments emphasis is given to the fact that the trial court made no finding that taxpayer's surplus had or had not been accumulated beyond the reasonable needs of the business. (Br. 5-6, 23.)

Whether the taxpayer was availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of permitting its earnings to accumulate was a pure question of fact which could be determined from all the evidence. *Commissioner v. Cecil B. DeMille Productions*, 90 F. (2d) 12 (C.C.A. 9th); *McCutchin Drilling Co. v. Commissioner, supra*; *Olin Corp. v. Commissioner*, 128 F. (2d) 185 (C.C.A. 7th). The court was not required to find that the taxpayer had permitted its earnings to accumulate beyond the reasonable needs of its business. While this is one item of evidence which may be relevant to the ultimate factual question of the taxpayer's purpose, the court could have found such purpose even if the accumulations were not beyond the reasonable needs of the taxpayer's business. *United Business Corp. v. Commissioner*, 62 F. (2d) 754

(C.C.A. 2d), certiorari denied, 290 U. S. 635; *A. D. Saenger, Inc. v. Commissioner*, 84 F. (2d) 23 (C.C.A. 5th), certiorari denied, 299 U. S. 577; *Trico Products Corp. v. Commissioner*, *supra*; *R. L. Blaffer & Co. v. Commissioner*, *supra*.

It is true that taxpayer as a part of its case sought to explain its failure to distribute larger dividends than it did on the ground that it had contingent business needs for which it required the accumulation of earnings. But the trial court need not have made any finding thereon, because this was not enough. The trial court could have considered that a family corporation such as this could have been equally well protected against contingencies by distributing the earnings and having its stockholders rather than the corporation invest them in securities. *Helvering v. Stock Yards Co.*, *supra*; *Helvering v. Nat. Grocery Co.*, *supra*; *Stanton Corp. v. Commissioner*, *supra*; *World Pub. Co. v. United States*, 72 Fed. Supp. 886 (N.D. Okla.). Taxpayer had the burden of proving not merely reasonable, possible, or actual purposes for accumulation of its earnings but that together with all other purposes there was not consistently included to any extent, and even if not dominant, a purpose to prevent the imposition of surtax upon its shareholders. *Helvering v. Stock Yards Co.*, *supra*; *Trico Products Corp. v. Commissioner*, *supra*; *R. L. Blaffer & Co. v. Commissioner*, *supra*; *Wilson Bros. & Co. v. Commissioner*, *supra*; *Whitney Chain & Mfg. Co. v. Commissioner*, 3 T.C. 1109.

The case of *Hemphill Schools v. Commissioner*, *supra*, decided by this court, is not inconsistent with the above. There the court reversed the holding of the Board of Tax Appeals because it had rested its decision upon the Commissioner's determination that the taxpayer had per-

mitted its earnings and profits to accumulate beyond the reasonable needs of its business but had not found whether or not this was so. There is nothing to show that here the District Court was guilty of the same error. Conceivably, in rejecting Overton's testimony that he did not have the purpose of avoiding surtax the court may have found that the accumulations during the tax years were not reasonable for the business needs, but as has been argued, it need not have arrived at its conclusion by that route at all.

It is submitted that the record provides ample support for the District Court's finding that during 1939 and 1940 taxpayer was availed of for the purpose of preventing the imposition of surtax upon its stockholders through the medium of permitting its earnings and profits to accumulate, and that the court's finding was not clearly erroneous.

### Conclusion.

The judgment of the District Court was correct and should be affirmed.

Respectfully submitted,

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## APPENDIX.

### Internal Revenue Code:

#### SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) Imposition of Tax. There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

25 per centum of the amount of the undistributed section 102 net income not in excess of \$100,000, plus

35 per centum of the undistributed section 102 net income in excess of \$100,000.

(b) *Prima Facie* Evidence.—The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.

(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary. (26 U. S. C. 1946 ed., Sec. 102.)

Section 102(a), (b), and (c) of the Revenue Act of 1938, c. 289, 52 Stat. 447, is substantially identical with Section 102(a), (b), and (c) of the Internal Revenue Code.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.102-2. PURPOSE TO AVOID SURTAX; EVIDENCE; BURDEN OF PROOF; DEFINITION OF HOLDING OR INVESTMENT COMPANY.—The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to disproof by competent evidence. The existence or nonexistence of the purpose may be indicated by circumstances other than evidence specified in the Internal Revenue Code, and whether or not such purpose was present depends upon the particular circumstances of each case. In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered: (1) Dealings between the corporation and its shareholders,

such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders.

If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation *is* a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation

is a mere holding or investment company, the existence of such an accumulation is *determinative* of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable.

A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

Article 102-2 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, is substantially identical with Section 19.102-2 of Treasury Regulations 103.